

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Area Counsel
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subject: Imposition of Section 6651(f) Fraudulent Failure to File Penalty and pay over Trust
Fund Penalties

This Chief Counsel Advice responds to your request for assistance. This advice may
not be used or cited as precedent.

LEGEND

Corporation A	=
Shareholder B	=
Shareholder C	=
State D	=
Year 1	=
Year 2	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=

ISSUES

1. May the Service impose an I.R.C. § 6651(f) penalty for fraudulent failure to file on a corporation for the acts of its sole shareholders and officers?
2. Whether it is appropriate to assert the Fraudulent Failure to File Penalty under I.R.C. § 6651(f) on Corporation A under the facts of this case.
3. What other penalties might be imposed on Corporation A in addition to or as an alternative to I.R.C. § 6651(f)?

CONCLUSIONS

1. The Service may impose an I.R.C. § 6651(f) penalty for fraudulent failure to file on a corporation for the acts of its sole shareholders and officers?
2. It may be appropriate to assert the Fraudulent Failure to File Penalty under I.R.C. § 6651(f) under the facts of this case.
3. Other penalties might be imposed on Corporation A in addition to or as an alternative to I.R.C. § 6651(f), including the failure to file penalty under I.R.C. § 6651(a), the failure to deposit penalty under I.R.C. § 6656, and the failure to collect and pay over tax under I.R.C. § 6672.

FACTS

Corporation A was formed in Year 1 and is a C corporation. Shareholder B and Shareholder C (husband and wife) are 100% shareholders of Corporation A and are president and secretary of Corporation A respectively. Corporation A employed workers in its business from Year 2 through Year 11. For all quarters under audit, Year 6 through Year 10, Corporation A paid wages to its employees. Both Shareholder B and Shareholder C are employees of Corporation A and were paid wages for the tax years at issue.

Corporation A withheld federal income taxes, FICA (social security and Medicare) taxes and issued Forms W-2s to employees reflecting that such taxes had been withheld, but not that they had been paid. Corporation A filed employment tax returns with State D for the Year 1 through Year 5 tax years; however, Corporation A did not pay any trust fund taxes for the Year 6 through Year 10 tax years, nor did the company file Forms 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, or Forms 941, Employer's Quarterly Federal Tax Return, for the years at issue.

During the years at issue, Corporation A had ample funds with which to pay over the trust fund taxes, but chose to use those funds to pay for the personal expenditures of Shareholder B and Shareholder C, including expenses relating to the purchase of land,

two automobiles, a watercraft, flooring and kitchen counter tops for Shareholder B and Shareholder C's residence; payments to a related company owned by Shareholder B's father; and payments to lease a third automobile.

With the knowledge that the withholdings had not been paid over to the federal government, Shareholder B's and Shareholder C's claimed federal income tax withholdings on their personal income tax returns and received refunds. Although this case has over the years been assigned to four different revenue agents, Shareholder B and Shareholder C also refused to cooperate with revenue agents assigned to the examination of Corporation A and failed to attend scheduled meetings. Because Shareholder B and Shareholder C failed to show or have cancelled their appointments, they have not been interviewed and have not provided any defenses.

In response to a summons enforcement action, Corporation A submitted delinquent Form 941 returns along with copies of Form W-3s and Form W-2s for Year 8, Year 9, and Year 10. Corporation A, however, failed to remit taxes withheld from employees and also failed to remit the employer's share of FICA taxes for Year 6, Year 7, Year 8, Year 9 and Year 10. As of the writing of this memo, Corporation A has not filed Forms 940 for Year 6, Year 7, Year 8, Year 9, and Year 10.

LAW AND ANALYSIS

Attributing Fraudulent Intent of Officers to the Corporation:

"[A] corporation can act only through its officers and ... it does not escape responsibility for acts of its officers performed in its capacity. Corporate fraud necessarily depends upon the fraudulent effect of the corporate officer." *Hi-Q Personnel, Inc. v. Commissioner*, 132 T.C. No. 13, slip op. at 22 (May 4, 2009), *citing Federbush v. Commissioner*, 34 T.C. 740, 749 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963). *See also DiLeo v. Commissioner*, 96 T.C. 858, 875 (1991). "Also, fraud of a sole or dominant shareholder can be attributed to the corporation. *Sam Kong Fashions, Inc. v. Commissioner*, T.C. Memo. 2005-157, 89 TCM 1503, 1511, *citing, Gold Bar, Inc. v. Commissioner*, T.C. Memo. 2000-211. Accordingly, the Service may impose an I.R.C. § 6651(f) penalty for fraudulent failure to file on a corporation for the acts of its sole shareholders and officers. Consequently, in order to determine whether to Corporation A acted with fraudulent intent, the Service should examine the conduct of Shareholder B and Shareholder C.

I.R.C. § 6651(f) Fraudulent Failure to File

Section 6651(a)(1) of the Internal Revenue Code (Code) imposes a penalty on a taxpayer that fail to file any required return by the due date for filing that return (determined with regard to any extension for filing), unless a taxpayer shows that such failure is due to reasonable cause and not to willful neglect. The penalty for a failure to timely file a return under Code Section 6651 applies to withholding tax returns, including

Form 941. Treas. Reg. § 31.6071(a)-1(e), Rev. Rul. 72-161, 1972-1 C.B. 397, *Charlotte's Office Boutique, Inc. v. Commissioner*, T.C. Memo. 2004-43. Where the failure to file such a return is due to fraud, I.R.C. § 6651(f) increases this penalty from 5 percent to 15 percent of the amount of tax required to be shown on the return if the failure does not exceed one month, and 15 percent for each additional month, not exceeding 75 percent in the aggregate.

The taxpayer bears the burden of showing that the delinquency was due to reasonable cause and not willful neglect. I.R.C. § 6651(a)(1); Treas. Reg. § 301.6651-1(c); *United States v. Boyle*, 469 U.S. 241, 245 (1985). The Service must prove fraud by clear and convincing evidence. I.R.C. § 7454(a); *Bradford v. Commissioner*, 796 F.2d 303, 307 (9th Cir. 1986); *Clayton v. Commissioner*, 102 T.C. 632, 646 (1994). The same factors used to evaluate the imposition of the fraud penalty under former I.R.C. § 6653(b) and under I.R.C. § 6663 are used in evaluating the addition to tax for fraud under I.R.C. § 6651(f). *Clayton*, 102 T.C. at 653. In determining whether a failure to file a return is fraudulent under I.R.C. § 6651(f), the Service must show (1) an underpayment of tax, and (2) at least a portion of the underpayment was due to fraud. *Sherrer v. Commissioner*, T.C. Memo 1999-122, *aff'd* in an unpublished opinion, 2001-1 U.S.T.C. (CCH) ¶ 50,280 (9th Cir. 2001)).

The Ninth Circuit defines fraud as an “intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing.” *Edelson v. Commissioner*, 829 F.2d 828, 833 (9th Cir. 1987); *Bradford*, 796 F.2d at 307. *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958). The existence of fraud is a question of fact, but intent may be inferred from circumstantial evidence. *Alexander Shokai, Inc. v. Commissioner*, 34 F.3d 1480, 1487 (9th Cir. 1994); *Laurins v. Commissioner*, 889 F.2d 910, 913 (9th Cir. 1989); *Powell*, 252 F.2d at 61. Circumstantial evidence may include “any conduct, the likely effect of which would be to mislead or conceal.” *United States v. Walton*, 909 F.2d 915, 926 (6th Cir. 1990) (*quoting Spies v. United States*, 317 U.S. 492, 499 (1943)).

Courts rely on a nonexclusive list of “badges of fraud” from which fraudulent intent may be inferred. These badges include (1) failure to file tax returns, (2) understatement of income, (3) failure to cooperate with tax authorities, (4) inadequate records, (5) implausible or inconsistent explanations of behavior, (6) concealment of assets, (7) engaging in illegal activities, (8) failing to make estimated tax payments, and (9) filing a false tax return. See e.g. *Alexander Shokai*, 34 F.3d at 1487; *Laurins*, 889 F.2d at 913; *Bradford*, 796 F.2d at 307; *Powell v. Granquist*, 146 F. Supp. 308, 310 (D. Or. 1956), *aff'd*, 252 F.2d 56 (9th Cir. 1958). While no single factor is necessarily sufficient to establish fraud, the existence of several indicia may constitute persuasive circumstantial evidence of fraud. *Petzoldt v. Commissioner*, 92 T.C. 661, 700 (1989).

Failure to file alone is not sufficient to establish fraudulent intent, but rather will be considered in conjunction with other acts and may constitute persuasive evidence of fraudulent intent where the failure to file occurs over an extended period of time. *Sherrer*, 77 TCM at 1803, *Kotmair v. Commissioner*, 86 T.C. 1253, 1260 (1986);

Stoltzfus v. U.S., 398 F.2d 1002, 1005 (3d Cir. 2968). Prior filing evidences knowledge of the duty to file. *Petzholdt v. Commissioner*, 92 T.C. 661, 701 (1989).

Badges of Fraud

Failure to File Returns

It may be appropriate to assert the fraudulent failure to file penalty under I.R.C. § 6651(f) under the facts of this case. First, there is an intentional failure or refusal to file returns over an extended period of time. Beginning in Year 6, Corporation A stopped filing its employment and corporate tax returns. This non-filing behavior continued for five years. Corporation A filed returns for previous years and filed employment tax returns with State D. Those filings show that Shareholder A and Shareholder B were aware of the filing responsibilities and yet still failed to file for a five year period.

Lack of Cooperation

Besides the failure to file returns for a series of years, there are other and independent evidence of fraudulent intent. Although the case has been assigned to four different revenue agents since it was initiated in Year 11, Shareholder B and Shareholder C have not cooperated with any of them. Because they have failed to appear for or cancelled appointments, they have not been interviewed or presented any defenses.

Shareholders Utilized Trust Fund Moneys for Personal Benefit

Shareholder A and Shareholder B claimed income tax withholding on their personal income tax while knowing that the trust fund taxes had not been paid over to the government. These personal expenditures include expenses relating to the purchase of land, two automobiles, a watercraft, flooring and kitchen counter tops for Shareholder B and Shareholder C's residence; payments to a related company owned by Shareholder B's father; and payments to lease a third automobile.

Filing a False Tax Return

In addition to using trust fund money for their own benefit, by claiming income tax withholding on Shareholder B's and Shareholder C's personal income tax return, and receiving refunds, despite knowingly never paying over the trust fund taxes, the Shareholders have filed false tax returns. We believe this is a factor that may constitute an additional badge of fraud, since they are the sole shareholders and are officers of Corporation A.

Penalties in Addition to § 6651(f)

I.R.C. § 6651(a)(1) and (a)(2)

Where the failure to file cannot be attributed to fraud, I.R.C. § 6651(a) imposes a penalty for the failure to file quarterly returns and pay the required withholding tax. These penalties may be imposed where the failures result from willful neglect and not reasonable cause. A preference for paying other creditors of the corporation constitutes

willful neglect. *United States v. Leuschner*, 336 F.2d 246, 247-248 (9th Cir. 1964) (citing *Bloom v. United States*, 272 F.2d 215 (9th Cir. 1959)).

I.R.C. § 6656 Failure to Make Deposits

I.R.C. § 6656 authorizes the imposition of an addition to tax not to exceed 15 percent for the failure to deposit employment taxes with an authorized depository unless such failure is due to reasonable cause and not willful neglect. In order to avoid the penalty, a taxpayer must make an affirmative showing of all the facts alleged as a reasonable cause in a written statement containing a declaration that it is made under penalties of perjury. This penalty may be imposed in conjunction with the penalties under I.R.C. § 6651.

I.R.C. § 6672 Failure to Collect and Pay Over Tax

An employer is required to withhold Federal income tax and Federal Insurance Contributions Act (FICA) taxes from employees. In addition, the employer is required to pay FICA taxes equivalent to the amount withheld from the employee and to pay Federal Unemployment Tax Act (FUTA) taxes on the employees wages, pursuant to I.R.C. §§ 3111 and 3301. When the person responsible for collection and payment of such taxes willfully fails to pay over withheld trust fund taxes, a penalty equal to the amount of the delinquent trust fund taxes may be assessed pursuant to I.R.C. § 6672(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Fraud is determined on a facts and circumstances basis, 



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Please call (202) 622-4910 if you have any further questions.

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